

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

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CC:PSI:3

PLR-144459-09

Date:

March 12, 2010

### LEGEND

Company =

Shareholders =

Date1 =

Date2 =

Date3 =

Year1 =

Year2 =

Year3 =

Year4 =

State =

Dear :

This letter responds to your letter dated September 21, 2009, and subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code.

### FACTS

Company incorporated in State on Date1. On Date2, Company filed Form 2553, Election by a Small Business Corporation, effective Date2. At the time of its S Corporation election, Company had accumulated earnings and profits leftover from the years it was a C corporation. In Year1, Company sold its operations to a third party. Company received an installment note for a portion of the purchase price. In addition, Company maintained its corporate existence, and kept the note and cash reserves in an escrow account in Company's name. This was required by the buyer to insure against any unforeseen liabilities for which Company would have been responsible.

On Date3, Company inadvertently terminated its S election pursuant to § 1362(d)(3). Specifically, in Year2, Year3 and Year4, Company had no earnings other than interest income from the note and escrow account holdings that existed after the sale of its business operations. In addition, in Year2, Year3, and Year4, Company still had accumulated earnings and profits that had carried over from the time it was a C corporation.

Company represents that there was no intent to terminate Company's S corporation election and that the combination of passive income and accumulated earnings and profits was inadvertent and not motivated by tax avoidance or retroactive tax planning. For all taxable years, Company and Company's shareholders' reported income consistent with Company qualifying as an S corporation. Moreover, since the time it discovered the termination, Company has distributed all of its earnings and profits to its Shareholders in proportion to their shares. In addition, Company and Company's shareholders agree to make any adjustments consistent with the treatment of Company as an S corporation as the Secretary may require with respect to the period specified by § 1362(f).

### LAW AND ANALYSIS

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible shareholder and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation (I) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and (II) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) provides that except as otherwise provided in § 1362(d)(3)(C), the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, and annuities.

Section 1362(f) provides, in relevant part, that if an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken so that the corporation for which the termination occurred is a small business corporation; and (4) the corporation for which the termination occurred, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agree to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that for purposes of § 1.1362-4(a) the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.

## CONCLUSION

Based solely on the facts submitted and representations made, we conclude that Company's S corporation election was terminated on Date3, the first taxable year after three consecutive years in which Company had accumulated earnings and profits, and also in which more than 25 percent of its income was passive activity income. We further conclude that the termination was inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), Company will be treated as continuing to be an S corporation on and after Date3, unless Company's S corporation election is otherwise terminated under § 1362(d).

Except for the specific ruling above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company's eligibility to be an S corporation.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

Leslie H. Finlow  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

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